Supreme Court, U.S.
FILED
NOV 1 1993
OFFICE OF THE CLERK

No. 93-520

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

GEOFFREY, INC.,
Petitioner,

v.

SOUTH CAROLINA DEPARTMENT OF
REVENUE AND TAXATION,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of South Carolina

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BRIEF OF AMICUS CURIAE NATIONAL RETAIL FEDERATION IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether the "substantial nexus" requirement of the Commerce Clause or the "minimum contacts" requirement of the Due Process Clause precludes a state from imposing an income tax upon a corporation with no physical presence in the state but whose trademarks are used in the state by a licensee.

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BRIEF OF AMICUS CURIAE NATIONAL RETAIL FEDERATION IN SUPPORT OF PETITIONER

INTEREST OF AMICUS CURIAE

The National Retail Federation ("NRF"), created to promote and protect the interests of the retail industry, is the largest national trade association of retailers. The retail industry itself consists of over 1.3 million U.S. retail establishments, employs nearly 20 million people, and registered sales in excess of $1.9 trillion in 1992. The NRF represents a wide spectrum of interests within that industry including the nation's leading department, chain, discount, specialty, and independent stores, several dozen national retail associations, and all 50 state retail associations.

The members of NRF are among the vast number of taxpayers who have relied upon the principle—previously

articulated and consistently applied by this Court—that a taxpayer's physical presence in a state is an essential prerequisite to the exercise of state tax power under the Commerce Clause. The South Carolina Supreme Court's decision in this case has placed this principle in jeopardy. The uncertainty and chaos in state tax administration that will inevitably result if the South Carolina court's decision is allowed to stand will directly affect the members of NRF as well as numerous other taxpayers. For example, taxpayers will be exposed to income tax in states in which they have no physical presence and in which they reasonably believed themselves immune from tax by this Court's prior rulings. Taxpayers will be required to reassess their business structure and compliance standards under the South Carolina court's novel conception of state taxing jurisdiction. NRF therefore has a strong interest in the issues presented in the certiorari petition.[1]

SUMMARY OF ARGUMENT

NRF urges this Court to grant review in this case for two reasons. First, the South Carolina Supreme Court's decision conflicts with the principle long applied by this Court, and relied upon by taxpayers everywhere, that physical presence is an essential component of state tax nexus under the Commerce Clause. Unless reviewed by this Court, the South Carolina court's assault on the "substantial nexus" criterion of the Commerce Clause will undermine fundamental restraints on state taxation of interstate commerce. Second, if left undisturbed, the South Carolina court's ruling will have an enormous adverse impact upon state taxpayers. Not only will the decision impose severe and unanticipated economic burdens upon taxpayers who have reasonably relied upon established principles of state tax jurisdiction, it will also create chaos in state tax administration as taxpayers and taxing au-

[1] Letters from the parties consenting to the filing of this brief have been filed with the Clerk of this Court. *See* Sup. Ct. R. 37.2.

thorities struggle to adjust to the extraordinary repercussions of the South Carolina court's decision.

ARGUMENT

I. THE SOUTH CAROLINA SUPREME COURT'S DECISION IS AT ODDS WITH THIS COURT'S UNBROKEN LINE OF DECISIONS PRECLUDING A STATE FROM IMPOSING A TAX UPON A CORPORATION WITH NO PHYSICAL PRESENCE IN THE STATE

In a decision with far-reaching implications for the constitutional restraints on state tax power, the South Carolina Supreme Court has ruled that a state has sufficient nexus with a foreign corporation to subject it to the state's income tax even though the corporation has no physical presence in the state. In so holding, the state court has extended the reach of South Carolina's taxing power far beyond the limits heretofore recognized by this Court.

This Court has consistently found that physical presence is an essential prerequisite to taxing nexus under the Commerce Clause. In *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967) for example, the Court acknowledged that it could not uphold the state's power to impose use tax burdens on an out-of-state mail-order seller with no physical presence in the state without "repudiat[ing] totally the *sharp distinction* . . . [its] decisions have drawn between mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business." *Id.* at 758 (emphasis supplied).[2]

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[2] For this proposition, the Court cited, among other cases, *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359 (1941) (power of a state to impose liability on an out-of-state seller to collect a use tax upheld where seller maintained local retail stores); *Felt & Tarrant Co. v. Gallagher*, 306 U.S. 62 (1939) (power of a state to impose liability

The Court concluded that this "basic distinction" between a taxpayer with physical presence in a state and a taxpayer with no physical presence in a state "is a valid one, and we decline to obliterate it." *Id.* at 758.

The Court emphatically reaffirmed the continuing validity of this distinction in *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992), holding that the Commerce Clause precludes a state from requiring an out-of-state mail-order seller with no physical presence in the state to collect and pay use tax on goods sold to customers for use within the state. Recognizing that "the Commerce Clause, and its nexus requirement, are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy" (*id* at 1913), the Court reiterated the "bright-line, physical-presence requirement" of *National Bellas Hess* that must be established before a state can assert its taxing jurisdiction and impose sales and use tax.

Although the Court has explicitly articulated the bright-line, physical-presence test only in cases involving sales and use tax, it has not abandoned that requirement in cases involving other types of taxes. On the contrary, the Court has *never* held that the "substantial nexus" requirement of the Commerce Clause can be satisfied in the absence of the taxpayer's physical presence in the state. The Court observed in *Quill* that all of the cases cited by the North Dakota Supreme Court as evidence of this Court's retreat from a physical-presence requirement, actually "involved taxpayers who had a physical presence in the taxing state and therefore do not directly conflict with the rule of *Bellas Hess* . . . ." *Quill*, 112 S.Ct. at 1914. Similarly, although the Court acknowledged that,

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on an out-of-state seller to collect a use tax upheld where sales were arranged by local agents in the taxing state); *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954) (attempt of state to impose liability on an out-of-state seller to collect a use tax prohibited where seller had no retail outlets or sales solicitors in state).

in its review of other types of taxes, it had not explicitly articulated the same physical-presence requirement that *National Bellas Hess* established for sales and use taxes, the Court was clear to point out that "that silence does not imply repudiation of the *Bellas Hess* rule." *Quill* at 1914.

Indeed, in *National Geographic Soc'y v. State Bd. of Equalization*, 430 U.S. 551 (1977), this Court suggested that a state may have to establish even more significant contacts with a taxpayer in order to sustain the imposition of a direct tax, such as an income tax, than to sustain the imposition of mere use-tax-collection responsibilities. *Id.* at 558. The Court pointed out that, unlike the burden imposed by an income tax, the sole burden on an out-of-state seller forced to collect use tax is an administrative one. *Id.* Moreover, when only use-tax-collection responsibilities, as opposed to income tax liability, is at issue there is "no risk of double taxation . . . [t]he consumer's identification as a resident of the taxing state is self-evident" and "[t]he out-of-state seller becomes liable for the tax only by failing or refusing to collect the tax from that resident consumer." *Id.* In light of this Court's reasoning, taxpayers everywhere can hardly be blamed for reaching the conclusion that, at the very least, a taxpayer must have some physical presence in a state before that state can impose an income tax.

The clear principle of taxation established by this Court, both explicitly and implicitly, is that physical presence is an indispensable precondition to the exercise of state tax power under the Commerce Clause. The South Carolina Supreme Court has issued a decision that ignores that clear principle, thereby unilaterally redefining the boundaries of state taxing jurisdiction. The lower court's disregard of this Court's criteria for determining when a state has taxing jurisdiction plainly warrants this Court's plenary review. At the very least, it is the prerogative of this Court—not a state court—to determine whether its established principles of state tax jurisdiction should be

overturned. *Rodriguez de Quijas v. Shearson American Express, Inc.*, 490 U.S. 477, 484 (1989).

II. THE SOUTH CAROLINA SUPREME COURT'S DECISION RAISES CONCERNS OF GREAT PRACTICAL SIGNIFICANCE THAT SHOULD BE CONSIDERED BY THIS COURT

Wholly apart from the conflict that the South Carolina decision creates with prior decisions of this Court, the decision's practical implications are so inimical to the free trade purposes underlying the Commerce Clause that it should not be left to stand. In essence, the decision has redefined the boundaries of state taxing jurisdiction. The consequences of this revised vision of state taxing power have enormous consequences for taxpayers, including small retailers and individuals who have businesses that stretch across state lines. In its certiorari petition, Geoffrey apprised the Court of some of the astonishing ramifications of the decision below. *See* Pet. at 9, 20-23.[3] While the implications of the state court's decision are a source of considerable anxiety to members of NRF, amicus will not burden this Court with a rehearsal of that "parade of horribles." Pet. at 20. Rather, amicus wishes to draw the Court's attention to some additional repercussions of South Carolina's decision that create special problems for the retail industry.

First, the state court's decision will create an artificial distinction between sales and use taxes and income taxes that will affect all types of enterprises, but especially retailers. Under this Court's precedents in *National Bellas Hess* and *Quill*, an out-of-state retailer with no physical presence in a state will not be subject to sales and use tax collection responsibilities in that state; however, the decision below, if left undisturbed, will allow a state to impose an income tax on an out-of-state retailer if that retailer's intangible property is used by others in the

[3] Citations to the petition for a writ of certiorari in this case are designated "Pet." followed by a page reference.

state. A situation thus will be created whereby the very same transaction may subject an out-of-state retailer to direct income taxation but not to sales and use taxation collection responsibilities.

The anomalous effects of such a situation are best demonstrated by applying the rule of the decision below to the fact pattern in *National Bellas Hess*, a case regularly cited as an example of the constitutional protection guaranteed to retailers engaged in interstate commerce. The taxpayer in *National Bellas Hess* was an out-of-state mail-order retailer with no physical presence in Illinois. Despite the lack of physical presence, the taxpayer directed an extensive credit operation in the state. *See National Bellas Hess* at 761 (Fortas, J., dissenting). Indeed, it appears that a substantial part of National Bellas Hess' sales were on credit with many purchases requiring no money down but rather monthly payments which included a service fee or interest charge. *Id.* In South Carolina's "brave new world of state taxing jurisdiction" (Pet. at 22), the use of any intangibles in a state, including accounts receivable such as those created by the credit transactions in *National Bellas Hess*, will subject the owner of those intangibles to income tax in that state. Ironically, therefore, the very same retail transaction that the Commerce Clause shields from the reach of Illinois' sales and use tax jurisdiction under *National Bellas Hess* (and now *Quill*) would not be so protected from Illinois' income tax jurisdiction under the decision below. The Commerce Clause analysis that would justify such a bifurcated treatment of a single transaction is difficult to fathom. In any event, this Court should not relegate to the cursory opinion of the court below the promulgation of a Commerce Clause doctrine that countenances one nexus standard for sales and use taxes and a different and even lower standard for income taxes which impose as great of a burden on interstate commerce and where a bright-line test would be equally beneficial.

As well as being theoretically unsupportable, an artificial distinction between sales and use taxes and income taxes will throw state tax administration into disarray with particularly unfavorable consequences for retailers. The settled rules by which retailers have structured their operations and to which they have conformed their reporting obligations will suddenly be characterized by confusion and uncertainty. State taxing authorities can be expected to press their new found taxing power to its logical limits, *see* Pet. at 20-22, with the result that taxpayers will be overwhelmed with income tax audits and assessments from every conceivable state and local jurisdiction in which the taxpayer has ever possessed accounts receivable or other intangible assets. This expansion of state taxing jurisdiction is of particular concern to the retail industry which often extends credit to its customers in addition to making retail sales.

Nor is this the only concern of retailers. The South Carolina decision could have a dramatic impact upon the relationship of the retail industry to its sister industry of manufacturing. Manufacturers often sell goods to retailers on credit thereby creating accounts receivable in various states where the manufacturer has no physical presence. Under South Carolina's expanded notion of taxing jurisdiction, such transactions would subject the manufacturers to income tax in the states in which the retailers operated. Similarly, retailers "use" a vast and diverse array of intangible property to sell merchandise. For example, a typical retailer sells goods bearing trademarks: (1) owned by the manufacturer (KLEENEX® tissue by Kimberly Clark); (2) licensed to the retailer by parties which do not sell the subject goods to the retailer (LIZ CLAIBORNE® clothing made by dozens of manufacturers); (3) licensed by manufacturers and used on goods sold to the retailer (MICKEY MOUSE® underwear sold by Wundies); and (4) owned by the retailer or its subsidiaries. The same four ownership regimes apply to ex-

ploitation of other forms of intangible property—patents, copyrights, trade names, and even trade secrets. Take each one of these intangible properties, multiply it by the tens of thousands of items sold in retail stores across the country and try to determine the tax liability of each retailer, each licensor, and each licensor of a manufacturer in any given state. This would be the logical result of the South Carolina Supreme Court's decision. Royalties for exploitation of such properties, if they are not paid outright as a separate fee, are built into prices at each step in the chain of distribution. The complexity of the task of identifying and paying the proper taxes is so great that non-compliance is virtually guaranteed.

The adverse impact of this exposure of manufacturers to tax in jurisdictions in which they have no ~~physical~~ presence will be significant. These adverse consequences include, but are not limited to the following: manufacturers will be less willing to extend credit to retailers; the cost of the use of tradenames will rise; the price of retail products will increase; litigation costs will increase dramatically; and significant tax consequences will result from retroactive application of taxing authority by states in which taxpayers have heretofore not filed income tax returns (due to no physical presence) and therefore the applicable statute of limitations has not expired.

The effect of the decision below will be considerable, and that effect will be disproportionately felt by NRF's small and individually-owned members. Indeed, the decision below may have a chilling effect on those least able to respond to the states' new demands. For example, the burdens on a housewife in the business of making brownie recipes available to chain stores may be prohibitive. New enterprises may be discouraged from starting up and small businesses may be forced to cut back on any activity that reaches across a state line.

In addition, the compliance burdens that will result from South Carolina's expanded definition of state tax

jurisdiction will be considerable. In *National Bellas Hess*, this Court recognized that saddling an out-of-state seller with use tax collection obligations would entail substantial burdens. The Court observed that "[t]he many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose a 'fair share of the cost of the local government.'" *National Bellas Hess* at 759-60. A similar, if not more onerous, burden would be imposed on taxpayers required to pay state and local income taxes in jurisdictions in which the taxpayer has no physical presence. The Court concluded in *National Bellas Hess* that "[t]he very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements." *Id.* at 760. The same conclusion applies here.

III. CONSIDERATIONS OF *STARE DECISIS* STRONGLY FAVOR REVIEW OF THE DECISION BELOW

Taxpayers have structured their businesses in reliance upon a set of principles established by this Court. *See supra* pp. 3-5. If South Carolina's decision is left undisturbed and these principles are abandoned, the economic hardship to taxpayers, both in terms of additional tax liability and in the cost of complying with a whole new set of jurisdictional rules, will be considerable. *See supra* pp. 5-9. Principles of *stare decisis* thus provide an additional reason for this Court to grant review of the decision below.

This Court has consistently placed great weight on reliance interests when invoking the doctrine of *stare decisis*. Indeed, "[c]onsiderations in favor of *stare decisis* are at their acme . . . where reliance interests are involved." *Payne v. Tennessee*, 111 S. Ct. 2597, 2610 (1991). In

Arkansas Electric Cooperative Corp. v. Arkansas Pub. Serv. Comm'n, 461 U.S. 375 (1983), this Court observed that "the principle of *stare decisis* counsels us here, as elsewhere, not lightly to set aside specific guidance of the sort we found in *Attleboro*." *Id.* at 391. The Court's decision in *Arkansas Electric* to set aside the rule of its earlier decision, was due in part to the fact that the Court could "see no strong reliance interests" that would be upset by the rejection of the rule.

Unlike the situation in *Arkansas Electric*, there are "strong reliance interests" at stake in this case. As the Court observed in *Quill*, the bright-line physical-presence requirement has "engendered substantial reliance and has become the framework of a sizeable industry." *Quill* at 1916. This is no less so in the income tax arena than in the sales and use tax arena. Businesses, including members of the NRF, have relied on this Court's precedents in structuring their commercial activity on the predicate that physical presence is a prerequisite to taxing nexus. Consequently, before allowing the South Carolina Supreme Court to jettison the established juridsictional principles reflected in this Court's earlier decisions (*see supra* pp. 3-5), and, along with them, the reasonable reliance interests of state taxpayers, it is incumbent upon this Court to consider those interests.

Moreover, there are other reasons for applying the bright-line, physical-presence test to income tax jurisdiction beyond the hardship suffered by taxpayers. Indeed, many of the reasons the Court articulated in *Quill* to justify the application of the bright-line rule to sales and use tax jurisdiction apply with equal force to income tax jurisdiction. Like a bright-line rule in the sales and use tax area, a bright-line rule in the income tax area "firmly establishes the boundaries of legitimate state authority . . . and reduces litigation. . . ." *Quill* at 1915. It "encourages settled expectations and, in doing so, fosters investment by businesses and individuals." *Id.* at 1915.

And it promotes the " 'orderly development of the law' that undergirds the doctrine of *stare decisis*. *Id.* at 1916 quoting *Runyon v. McCrary*, 427 U.S. 160, 190-191 (1976).

South Carolina has issued a decision that, in substance, rewrites the rules governing state taxing jurisdiction. Not only is this revision at odds with this Court's own criteria for state jurisdiction to tax, the decision below will subject taxpayers to sever economic burdens that they had no reason to anticipate. Principles of *stare decisis* therefore strongly counsel that this Court review the decision below.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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Dated: November 1, 1993